AR06

ASHLU EXPLORATION LTD

aex

1985 ANNUAL REPORT

1985

REPORT TO SHAREHOLDERS

The fiscal year ending December 31, 1985 ended on a positive note for Ashlu Exploration Ltd. and the oil industry in general. Ashlu had finally reached an agreement with the Company's Banker to restructure its long term debt so that payments were within the Company's means; additional gas was coming on production to provide increased revenue; and our overhead was substantially down. Within the industry, investor confidence was building and management could foresee an equity market. This positive ending to 1985 has since been totally devastated with a 60% drop in the price of oil in the first quarter of 1986. Ashlu is capable of surviving under our new banking agreement, however the drop in oil price has caused a drastic reduction in our capital budget and our prospect for growth will be limited in 1986.

FINANCIAL

Revenue in 1985 amounted to $731,444 generating cashflow of $230,027 (5¢/share) compared to cashflow of $147,984 (3¢/share) in 1984. Ashlu recorded a loss of $137,598 (4¢/share) in 1985 down from a loss of $880,505 (18¢/share) in 1984 which included an extraordinary loss of $765,285.

Net oil and gas sales were $717,353, up slightly over 1984, however production expenses of $246,338 showed an increase of $70,650 (40%) over 1984. This increase was primarily caused by placing on production several high operating cost wells at Virden, Midale and Lathom. The wells at Virden and Midale have now either been abandoned or shut-in which will have a marginal effect on revenue but a significant reduction on operating costs in 1986.

Due to relative inactivity, G & A expenses were reduced to $132,774 in 1985 down 54% over the sum of $288,866 in 1984. Interest costs were down $14,456 (8%) in 1985 which partly reflects the new banking agreement.

On October 23, 1985, Ashlu finally reached an agreement with its Banker to restructure the Company's long term debt over a period of time that is within Ashlu's cashflow capabilities. Under the terms of the agreement a portion of our long term debt has been deferred, which leads to an interest saving. The reduced interest expense amounts to an annual saving of approximately $160,000 on a cash basis and approximately $93,000 when the deferred notes are considered. Although this restructuring contemplated a capital budget out of cashflow, the recent decline in oil price has significantly reduced any capital expenditures. Despite this decline in prices Ashlu should be capable of meeting our overhead requirements, our banking commitment of $21,700/month along with a minimal capital budget.

OPERATIONAL REVIEW

Ashlu had varying interest in four wells drilled in 1985. This resulted in a significant oilwell at Mitsue, a gaswell and dry hole at Erskine and a dry hole at Rigel. Ashlu has a carried 1.4% overrriding royalty in a well drilled at Mitsue that tested in excess of 400 BOPD. This well is now on production with a daily allowable of 70 bbls. The Company participated as to 8.228% interest in acquiring a lease directly offsetting this particular well and another oilwell in which Ashlu has no interest. Detailed information is currently being held confidential.

At Erskine, Ashlu was carried for a 3% interest in a gaswell that has an AOF test in excess of 10 MMCF/d. We have now obtained a gas contract for 1 MMCF/d and production is expected to commence July 1, 1986.

In 1985 the Company had an independent engineering report prepared with an effective date of May 1985. Pursuant to this report the Company has net proven and probable reserves of 165,500 bbls. of oil and 3953.5 MMCF of gas with a 15% discounted value of $5,681,800. Of this value, 87% is classed as proven. This independent report was prepared prior to the decline in oil prices which management believes would reduce this value by 30% to 40%.

Gaswells at Dry Fork in Montana; and Little Bow and Erskine in Alberta, are expected to be on production in 1986 which will replace, in part, reduced oil revenue. During February 1986, 46% of our production income was from gas and this is expected to increase to approximately 60% by the end of 1986.

OUTLOOK

With the drop in oil prices, Ashlu will continue to struggle however, with additional gas coming on production, a full year's revenue from Elnora and Lathom, reduced interest and overhead costs, the impact of the reduced oil prices will be partially offset. A limited capital budget will restrict any growth for 1986. A firm Banking agreement has removed any uncertainty as to the future of Ashlu Exploration Ltd. Management must continue to be very conscious of maintaining a tight operation in order to assure our survival and eventual recovery.

Mr. Gene Vennard has tendered his resignation as a Board Member. I wish to thank Mr. Vennard for his advice and financial input into the Company over the past years. I am pleased to advise that Mr. Dave Kimmitt of the accounting firm of Stitt & Kimmitt has agreed to let his name stand for election to the Board of Directors at the June annual meeting. Mr. Kimmitt is a Chartered Accountant and will maintain the presence of a financial advisor on the Board.

On behalf of the Board of Directors

Hugh D. Borgland
President

ANNUAL GENERAL MEETING

11:00 a.m.
Friday, June 13, 1986
Sandman Office Tower
1150, 840 - 7 Avenue S.W.
Calgary, Alberta

FINANCIAL STATEMENTS

AUDITOR'S REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Ashlu Exploration Ltd. as at December 31, 1985 and the consolidated statements of loss, deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included in such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

COOPERS & LYBRAND
Chartered Accountants

Coopers & Lybrand

April 22, 1986

CONSOLIDATED BALANCE SHEET

As at December 31

	1985 $	1984 $
ASSETS		
CURRENT ASSETS		
Cash and short-term deposits	301,815	566,114
Accounts receivable	487,282	356,218
Due from related companies	—	2,567
Prepaid expenses	—	3,003
	789,097	927,902
PROPERTY AND EQUIPMENT (note 2)	5,226,603	5,418,138
OTHER ASSETS (note 3)	32,984	35,094
	6,048,684	6,381,134
LIABILITIES		
CURRENT LIABILITIES		
Bank loan	155,000	5,730
Accounts payable and accrued liabilities	1,042,842	1,084,445
	1,197,842	1,090,175
LONG-TERM DEBT (note 4)	2,599,560	2,940,968
	3,797,402	4,031,143
SHAREHOLDER'S EQUITY		
CAPITAL STOCK (note 5)	2,388,880	4,590,991
DEFICIT	(137,598)	(2,241,000)
	2,251,282	2,349,991
	6,048,684	6,381,134

Signed on behalf of the Board

Director

Director

CONSOLIDATED STATEMENT OF LOSS

For the year ended December 31

	1985 $	1984 $
INCOME		
Oil and gas sales	859,231	852,301
Royalties and production taxes	(176,226)	(169,244)
Alberta Royalty Tax Credit	34,348	28,458
	717,353	711,515
(Loss) gain on sale of petroleum and natural gas production properties	(38,913)	24,400
Other	45,693	53,661
Interest	7,311	6,551
	731,444	796,127
EXPENSES		
Production	246,338	175,680
General and administrative	132,774	288,866
Interest	158,578	173,034
Depreciation and depletion	298,712	273,765
	836,402	911,345
LOSS BEFORE OTHER CHARGES	104,958	115,218
OTHER CHARGES		
Foreign exchange loss	32,640	19,763
Write-down of U.S. petroleum and natural gas properties (note 4)	—	689,000
Write-down of investment in limited partnership	—	56,524
	32,640	765,287
LOSS FOR THE YEAR	137,598	880,505
PER SHARE DATA		
Earnings per common share	(4¢)	(18¢)
Cash flow per common share	5¢	3¢

CONSOLIDATED STATEMENT OF DEFICIT

For the year ended December 31

	1985 $	1984 $
DEFICIT - BEGINNING OF YEAR	2,241,000	1,327,370
Elimination of deficit against capital stock	(2,241,000)	—
Loss for the year	137,598	880,505
	137,598	2,207,875
Dividends on preferred shares	—	33,125
DEFICIT - END OF YEAR	137,598	2,241,000

NOTES TO FINANCIAL STATEMENTS

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the year ended December 31

	1985 $	1984 $
SOURCE OF WORKING CAPITAL		
(Loss) for the year	(137,598)	(880,505)
Items not affecting working capital —		
Depreciation and depletion	298,712	273,765
Write-down of U.S. petroleum and natural gas properties	—	689,000
Write-down of investment in limited partnership	—	56,524
Loss (gain) on sale of land held for resale	38,913	(24,400)
Proceeds on sale of land held for resale	30,000	33,600
Provided from operations	230,027	147,984
Proceeds on sale of petroleum and natural gas properties	20,056	205,357
Government incentive program payments	—	60,642
Investment in and advances to limited partnership	—	3,270
Share subscriptions	38,889	111,111
Other assets	2,110	11,562
	291,082	540,926
USE OF WORKING CAPITAL		
Additions to property and equipment	378,517	511,041
Dividends on preferred shares	—	33,125
Long-term debt	159,037	103,340
	537,554	647,506
DECREASE IN WORKING CAPITAL	246,472	106,580
WORKING CAPITAL DEFICIENCY — BEGINNING OF YEAR	162,273	55,693
WORKING CAPITAL DEFICIENCY — END OF YEAR	408,745	162,273

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the year ended December 31

1. ACCOUNTING POLICIES

Principles of consolidation

The consolidated financial statements include the accounts of the company and its wholly-owned subsidiary companies, Calto Development, Inc. and Concord Transmission Limited, both accounted for using the purchase method.

Translation of foreign currencies

Accounts maintained in foreign currencies have been translated into Canadian funds on the following basis: monetary assets and monetary liabilities at the rate of exchange in effect at the year-end; property and equipment at the rate at the time of acquisition; and revenues and expenses at the average rates for the year except for depreciation and depletion which are translated at the same rates as used for the related assets. Translation gains and losses are reflected in the statement of earnings.

Property and equipment

The company follows the full cost method of accounting for petroleum and natural gas properties wherein all costs relative to the exploration for and development of oil and gas reserves, including a portion of administrative and interest expenses, are capitalized. A separate cost centre is established for each country in which the company operates, presently Canada and the United States. Proceeds received from disposal of properties are ordinarily credited against accumulated costs without recognition of profit or loss except where such disposal constitutes a major portion of the cost centre's reserves. Depreciation and depletion of equipment and petroleum and natural gas properties are provided for by the unit-of-production method based on the company's total estimated proven reserves for each cost centre. Treating, compressing and related facilities are depreciated on a straight-line basis over their estimated useful lives of ten years.

The company carries its oil and gas properties at the lower of capitalized cost or net recoverable value. Net recoverable value is the aggregate of future net revenues from proven and risk adjusted probable reserves plus unproved properties at cost or fair value where value has been determined. Future net revenues are determined using current prices and current costs on an after-tax basis.

Earnings per share

Net earnings per share is calculated by dividing net earnings less dividends paid on preferred shares by the weighted average number of shares outstanding during the year. Potentially dilutive factors are anti-dilutive.

Joint ventures

Substantially all of the company's exploration and production activities are conducted jointly with others and the accounts reflect only the company's proportionate interest in such activities.

2. PROPERTY AND EQUIPMENT

	1985 $	1984 $
Petroleum and natural gas properties	6,014,131	5,842,743
Equipment	689,905	547,152
Treating, compressing and related facilities	186,800	178,262
	6,890,836	6,568,157
Less: accumulated depreciation and depletion	1,664,233	1,150,019
	5,226,603	5,418,138

General and administrative and interest expenditures incurred by the company during the years ended December 31, and the amounts capitalized as cost of properties, were as follows:

	1985 $	1984 $
General and administrative		
Total	206,047	392,866
Capitalized	60,000	104,000
Interest		
Total	278,578	311,034
Capitalized	120,000	138,000

The carrying value of property and equipment exceeds its value for tax purposes by approximately $1,500,000.

3. OTHER ASSETS

	1985 $	1984 $
Drilling deposits	19,884	21,994
Employee advances	13,100	13,100
	32,984	35,094

Winspear Business Library
1-18 Business Building
Edmonton, Alta. T6G 2R6

4. LONG-TERM DEBT

Long-term debt consists of the following:

	1985 $	1984 $
Canadian dollar demand, production bank loan bearing interest at the bank's prime rate plus ¾%, up to a maximum of 13%; interest at 7½% is payable monthly in cash and the remainder is payable by deferred notes due annually in January, commencing January 1, 1986	1,423,499	2,360,104
Canadian dollar demand, operating bank loan bearing interest at the bank's prime rate plus ¾%	192,000	—
United States dollar demand, production bank loan, interest free (U.S. $250,000; 1984 - U.S. $439,582)	349,375	580,864
Demand deferred notes, bearing interest at 10% on the first $770,000	789,686	—
	2,754,560	2,940,968
Less: current portion	155,000	—
	2,599,560	2,940,968

Security for the bank loans is provided by a general assignment of book debts, an assignment under section 177 of the Bank Act of the company's interest in certain petroleum and natural gas properties, equipment and related production and a floating charge debenture in the amount of $3,000,000.

The Canadian dollar production bank loan is to be repaid by consecutive monthly principal and interest installments of $21,700, the operating loan will revolve until August 1, 1986 at which time a repayment schedule will be determined, the United States dollar demand loan will be repaid from net production revenue from U.S. petroleum and natural gas properties and the demand, deferred notes are to be repaid from surplus cash flow. Surplus cash flow is calculated after the expenditure of the company's capital budget.

The company has recognized a reduction of $182,000 in the carrying value of its U.S. oil and gas properties and at the same time has recognized the benefit of uncollected interest expense of the same amount waived by the company's bankers.

The aggregate amount of payments required in each of the next five years to meet retirement provisions of the demand loans are as follows:

		$
Year ending December 31,	1986	155,000
	1987	165,000
	1988	180,000
	1989	190,000
	1990	205,000

5. CAPITAL STOCK

(a) Authorized —

25,000,000 common shares without par value

1,000,000 preferred shares without par value, issuable in series

(b) Issued and fully paid —

	1985 Shares	1985 $	1984 Shares	1984 $
Common shares				
Balance - beginning of year	4,393,193	4,050,346	4,393,193	4,050,346
Elimination of deficit		(2,241,000)		
Issued for resource expenditures less estimated government incentive payments	506,250	150,000		
Balance — end of year	4,899,443	1,959,346	4,393,193	4,050,346
Preferred shares, Series A				
Issued during year	66,250	429,534		
Balance — end of year	66,250	429,534		
(c) Obligation to issue				
Common shares				
To be issued for resource expenditures less government incentive payments			375,000	111,111
Preferred shares, Series A	—	—	66,250	429,534
		2,388,880		4,590,991

Elimination of deficit

At the company's annual general meeting held in Calgary on June 21, 1985, the shareholders approved, by special resolution, the elimination of the deficit by means of a reduction in the stated capital of the company. As at December 31, 1984, the shareholder's equipty of the company was as follows:

	$
Issued and fully paid -	
4,393,193 common shares	4,050,346
Obligations to issue -	
375,000 common shares	111,111
66,250 preferred shares, Series A	429,534
Deficit	(2,241,000)
	2,349,991

The effect of the above resolution was to adjust the shareholder's equity of the company to the following:

	$
Issued and fully paid —	
4,393,193 common shares	1,809,346
Obligations to issue —	
375,000 common shares	111,111
66,250 preferred shares, Series A	429,534
	2,349,991

Shares issued

During 1985, pursuant to a private placement memorandum the company issued 375,000 common shares in consideration for the subscribers incurring resource expenditures on company lands at a subscription price of $150,000 before government incentives. Incentive payments of approximately $39,000 receivable from the provincial and federal governments arising from the resource expenditures were re-invested in 1985 on exploration expenditures and in consideration, the company issued a further 131,250 common shares to the subscribers of the private placement.

During 1985, the company issued 66,250 preferred shares. The preferred shares, Series A, have a stated issue price of $10 per share and the holders are entitled to a fixed cumulative dividend of 10% per annum. The shares carry a conversion price of $1.25 per common share for a period of five years from subscription and $1.667 per common share for an additional five year period thereafter. The shares are redeemable at their stated issue price provided the trading price of the company's common shares over a twenty day period is not less than 130% of the conversion price. The company is committed to purchase 20% of the preferred shares outstanding at November 1, 1992 over the ensuing five years at their stated issue price of $10 together with unpaid dividends.

Dividends in arrears

The company has undeclared dividends in arrears on the preferred shares in the amount of $99,375 as at December 31, 1985 (1984 - $33,125).

Stock options

At December 31, 1985 options to purchase 305,000 common shares (including 60,000 to directors) were outstanding at prices of $0.30 and $0.20 per share. The options expire at various dates to October 15, 1987.

Pursuant to the terms of stock option agreements, an officer and director and former employees of the company borrowed funds to purchase common shares of the company. The loans in the amount of $13,100 (1984 - $13,100) are secured by the company's shares and are repayable, without interest, on June 30, 1986.

6. INCOME TAXES

The company has Canadian income tax losses and resource expenditures of approximately $3,700,000 which may be carried forward and utilized to reduce future Canadian taxable income. The income tax losses carried forward ($211,000) will expire in 1987. The company's U.S. subsidiary company has income tax losses of approximately $680,000 (U.S.) which may be carried forward and utilized to reduce future U.S. taxable income. These losses carried forward will expire in 1996. In addition, the company has allowable capital losses of approximately $120,000 which may be carried forward indefinitely and utilized to offset future taxable capital gains. No future tax benefit has been recognized in the accounts.

7. RELATED PARTY TRANSACTIONS

The company and its subsidiary company have entered into management agreements with a company controlled by an officer and director of the company. During the year, the company and a subsidiary company were charged $23,100 (1984 -$35,000) for services provided by the related company.

8. SEGMENT INFORMATION

The company's dominant industry is oil and gas exploration, development and production of petroleum and natural gas in Canada and the United States. Operations in the United States are insignificant and accordingly geographical information has not been presented.

9. SUBSEQUENT EVENT

Subsequent to the year-end, oil prices declined significantly and in November 1986 Canadian gas prices will be deregulated. If the present level of oil prices persists and gas prices fall significantly, the carrying value of the company's oil and gas properties may exceed their cost recovery ceiling calculated at the end of the company's next fiscal year and a write-down of the carrying value may be required. In view of the unstable market for company's oil and gas production, management is unable to determine what provision, if any, may be required.

CORPORATE INFORMATION

CAPITALIZATION

Common Shares
Authorized: 25,000,000 N.P.V.
Issued: 4,768,193

Preferred Shares
Authorized: 1,000,000 $10/share par value
Issued: 66,250

DIRECTORS & OFFICERS

Hugh D. Borgland
President & Director
Calgary, Alberta

J.L. Thorogood
Calgary, Alberta

D.J. Cartwright
Calgary, Alberta

Arthur F. Coady
Secretary & Director
Calgary, Alberta

SOLICITORS

Burstall & Company
2100, 801 - 6th Avenue S.W.
Calgary, Alberta
T2P 3W2

HEAD OFFICE

1150, 840 - 7th Avenue S.W.
Calgary, Alberta
T2P 3G2

REGISTERED OFFICE

2100, 801 - 6th Avenue S.W.
Calgary, Alberta
T2P 3W2

BANKERS

The Royal Bank of Canada
Main Branch
Calgary, Alberta

AUDITORS

Coopers & Lybrand
2400, 255 - 5th Avenue S.W.
Calgary, Alberta

REGISTRAR & TRANSFER AGENT

Montreal Trust
411 - 8th Avenue S.W.
Calgary, Alberta

SUBSIDIARY COMPANY

Calto Development, Inc.
Concord Transmission Limited

STOCK EXCHANGE LISTING

Alberta Stock Exchange
Symbol - AEX

Printed in Canada